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SUBJECT: FRANCE AND THE ECONOMIC/FINANCIAL CRISIS

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¶1. (SBU) Summary: France anticipates a steep but short-lived economic contraction in 2009, followed by a slow recovery, according to government and private sector economists. Sharp slowdowns in key trading partners (Germany, Spain) as well as longstanding problems with international competitiveness are weighing on the economy. A top French private sector economist tells us the downside risks include a smaller-than-expected U.S. stimulus package or another major bank failure (though she believes the latter unlikely). Outside of the financial sector, government policy initiatives focus on assisting small and medium-sized firms, the housing and automobile sectors, and very selective stimulus payments to households. At the same time, the GOF insists on the necessity of new policy coordination mechanisms at the European and international levels given the extent of economic globalization, a view it believes the Obama administration will share. End Summary

Economic Situation and Outlook

¶2. (SBU) The French economy contracted at an annual rate of 3.2 percent in the fourth quarter, dragging growth for the year down to 0.8 percent, estimates French statistics agency INSEE. This followed growth of 2.4 percent in 2006 and 2.1 percent in 2007. For the first half of 2009, INSEE forecasts a further contraction of over one percent. Barclays Capital economist Laurence Boone told us she expects fourth quarter 2008 and first quarter 2009 to be the depth of recession for France, with data likely to show a bottom by the end of the second quarter. Overall, she expects a 1.3 percent GDP contraction for 2009. COE-Rexecode Director Denis Ferrand foresees a "square-root-shaped" downward spike and initial rebound, followed by almost flat growth in the medium-term. Private sector projections for 2009 range from minus 0.5 to minus 2.1 percent, followed by slow recovery in 2010.

¶3. (SBU) Economics Minister Christine Lagarde has promised growth of 0.2-0.5 percent over 2009, once the effects of the GOF's economic stimulus package come through. Budget Minister Eric Woerth said in early January that he expects no downward revision of the government's current 2009 GDP growth forecast, a prospect that even INSEE finds optimistic. INSEE Chief Economist Eric Dubois explained to the press that for France to achieve zero growth in 2009, the

economy would need to grow 1.4 percent (5.7 percent annualized) in each of the last two quarters of the year. Dubois stressed that he thought this unlikely.

Credit Hits Business, Consumers Pay Cash (mostly)
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¶4. (SBU) The credit crunch has hit France largely through the corporate sector, where bank lending plays a critical role in balance sheets, particularly for SMEs. Credit tightening started to hit in mid-September (post-Lehman), and the impact has yet to be fully felt, according to Boone. Barclays' data indicate numerous corporate credit lines will expire at the end of the first quarter ¶2009. Boone expressed concern about renewal terms but does not foresee a "drastic collapse." French household savings average 15 percent of disposable income. Consumer credit is modest and tightly correlated to disposable income, and thus to employment. As a result, there is little wealth effect in consumer spending, and consumption has held up except in sectors like autos that are reliant on consumer credit.

Unemployment

¶5. (SBU) Unemployment is rising slowly from the early 2008 25-year low of 7.2 percent. INSEE expects 8 percent unemployment by June ¶2009. "Partial unemployment" picked up in November, and Barclays' Boone expects a sharp rise in the December - January unemployment numbers, which will weigh on consumer spending. Nevertheless the mood of the French consumer is not catastrophic, compared with the 1993 recession which saw unemployment at 12.5%.

¶6. (SBU) The increase in unemployment in 2008 is largely a result of

the more than 10 percent increase in bankruptcies, mostly from mid-year, and notably in the automobile, real estate and hospitality sectors. Economists expect bankruptcies to extend to all industrial sectors in 2009. However, Ferrand told us that the increase in unemployment may boost creation of new business, citing recent statistics showing that one third of start-ups are attributable to the unemployed as government measures to lighten bureaucratic and fiscal burden on very small firms encourage them to become entrepreneurs.

Key Factors

¶7. (SBU) Key factors weighing on the French economy include the global economy as well as the slowdown of close trading partners such as Spain and Germany. Experts all expect the drivers of the 2008 contraction to continue in 2009 including: contraction in the auto industry, reductions in inventories and a decline in exports (minus 9 percent, per INSEE). One of the biggest challenges for France is competitiveness which is weighed down by high labor costs and the difficulty of "growing" small firms.

French Policy Approaches

¶8. (U) In addition to its financial sector rescue programs (ref B), GOF measures focus on small and medium-sized firms, and the housing and automobile sectors. Both government and private sector economists believe that payments to households tend to be saved rather than spent. Instead, the government has focused its plans for direct payments on a recently-created negative income tax for households in the lowest income brackets. On December 4, President Sarkozy announced 26 billion euros for economic stimulus measures including 4 billion euros in transportation and energy infrastructure, 4 billion euros in "strategic" areas (research and development, higher education, defense), 4 billion euros in additional support for small business, 2.5 billion euros in support for local government investment projects, and the purchase or construction of 100,000 housing units. Employment-specific measures include waiving payroll taxes equivalent to minimum wage rates on new employees hired in 2009 by businesses with less than 10 employees. In addition, 500 million euros will be added to funding for incentive payments to those returning to the workforce who would otherwise experience a net drop in income due to lost unemployment

benefits. On the corporate side, advance tax payments will be reduced and reimbursement of tax overpayments will be accelerated to reduce the credit requirements of cash-strapped companies. On January 20, Prime Minister Fillon announced state aid to the automobile sector "on the order of 5 to 6 billion euros" but did not provide details.

Assessment of Government Measures

¶9. (SBU) The general assessment is that this stimulus package will add about 0.6 to 0.8 percent to GDP in 2009. The GOF's detailed information on the stimulus package indicates that some 11.6 billion of the 26 billion euros consists of accelerated tax refunds. Ferrand highlighted the importance of this cash-flow assistance in what he expects to be a sharp but fairly short-lived downturn. Barclays' economist Boone believes that accelerating tax rebates will have limited impact on industrial activity. She puts direct support to industrial activity from the stimulus package at 3 - 6 billion euros.

¶10. (SBU) Boone expressed concern that the GOF may move to extend bank guarantees for lending to the corporate sector in order to force lending to business by reluctant banks. The State is "not good at (picking winners)," and if everything has a guarantee it's "impossible to discriminate between good and bad." Business should not invest if it does not see demand. She expects the GOF budget deficit to reach 5.5 percent of GDP in 2009 (compared with the latest GOF projection of 4.4percent,) with the lion's share resulting from automatic stabilizers.

¶11. (SBU) SME's: Small and medium-sized firms account for

two-thirds of employment, and are particularly hard hit by the credit crunch. The GOF stimulus package provisions to reduce up-front tax payments or accelerate tax refunds are intended to allow more firms to remain solvent to grow again when the downturn ends. The 2007 tax credits for investments in innovative technology are beginning to show results and accelerated amortization of new investments is also receiving some government consideration.

¶12. (SBU) Autos: According to Ferrand, residential property and consumer durables including autos have been hardest hit since these sectors rely on consumer credit. Rising fuel prices through September and increasingly tight credit markets are responsible for a 20 percent decline in new car registration this year. However, auto production in France is down almost 60 percent since June, reflecting inventory reduction and reduced production, with temporary plant shut-downs towards the end of the year. With the auto sector accounting directly and indirectly for some 10 percent of employment in France, the government will complement demand-side measures (credits for trading in old vehicles for new, greener cars, plus 1 billion euros in low-interest loans to finance car purchases) with financial assistance to the industry, including PME component suppliers. If fuel prices remain at current levels and the rest of the economy does not significantly worsen, Ferrand reasoned, demand will drive higher levels of production.

¶13. (SBU) Comment: The impact of the financial crisis on the real economy in France remains moderate at this point, outside of the automotive and residential construction sectors. In part, this is due to the fact that French consumption is driven by current income, not wealth, and consumers rely little on consumer credit. Nonetheless, we expect to see a second-round deepening of recession as the crisis hits France's key trading partners in Europe and elsewhere as well as the travel, tourism and luxury goods sectors that are important to France. The GOF has had a multi-layered policy response. First, it has pressed for fuller European coordination on fiscal and monetary policy. The GOF is particularly proud of its success in convening for the first time Eurogroup heads of state with the president of the European Central Bank, perhaps beginning a new era of consolidated economic governance in Europe. Second, the GOF is fixated on the need for global governance mechanisms to ensure supervision and regulation of global finance and the globalized economy, more generally. There is a belief across the political mainstream that the interplay between finance

and the real economy in the current downturn justifies a new international approach in these areas and an "activist" state role in the economy, whether one calls it Colbertist or Gaullist. Finally, the French have high expectation that the Obama Administration will see eye-to-eye with them on many of these issues.

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